HOW TO READ A PROSPECTUS

A guide for beginning investors

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Robin Carnahan
Secretary of State**

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This pamphlet is intended to provide a general overview of the contents of prospectuses and an explanation about the more important information contained in a prospectus. Reading the prospectus is the best way to get detailed, precise information about a securities offering. There is no real short cut.

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In general

A prospectus is a written document that provides all material information about an offering of securities, and is the primary sales tool of the company that issues the securities (called the issuer) and broker-dealers that market the offering for the issuer (called underwriters).

A prospectus is also a legal document that protects the issuer and underwriters because it serves as written proof that you were given all of the material facts as they are set out in the prospectus. For that reason, you should be certain that you understand the disclosures made to you, and that all verbal explanations are consistent with the disclosures contained in the prospectus.

Be skeptical. If a claim or business plan does not look workable to you, perhaps it isn't.

Be assertive. Make sure that you are given a copy of the prospectus before you decide to invest and insist on help in reviewing the prospectus if you feel you need it.

Be inquisitive. Ask every question about the offering that occurs to you. If you need to, make a list of your questions. If you cannot get an answer to your questions, do not invest.

In some instances, there may be other written material about a proposed investment that is not referred to as a prospectus, but contains the kind of information generally contained in a prospectus. For example, a mutual fund prospectus is a short summary of the statement of additional information (SAI), a document in which the detailed disclosures are made. If the security is not being offered for the first time, the annual report, "10-Q's," "10-K's" and "8-K's" will contain much the same information as a prospectus.

Parts of a prospectus

The **front** page gives general information such as the issuer's name, type and amount of securities offered and whether there are any existing shareholders who are selling their shares. It states whether there is or is not a public market. It names the underwriter(s), states the amount of underwriter's compensation, and notes whether the offering is "firm commitment" or "best efforts." The front page will also indicate whether the prospectus is effective with the Securities and Exchange Commission (the effective date will appear), or is still "preliminary" (marked in red).

Summary information is a summary of the matters to be disclosed more fully in the prospectus and audited financial statements. Take time to read the fine print in the footnotes.

Certain considerations is the risk factor section. Read it very carefully. If it is not included, be very skeptical about the investment. Each risk factor should have substantially more disclosure somewhere else in the prospectus. Look for each one.

A litigation section, which summarizes all ongoing material litigation, may or may not be included, depending on whether there is any. Although the risk factors will generally refer to this section, if there is one, it is a good idea to look for one even if it is not mentioned.

The **company** section gives the history, type of operation, location(s) of operations, and general business plan. This information is expanded in a subsequent section entitled "Business."

The **use of proceeds** section is very important. Don't invest unless this section can explain how your investment capital will be used.

A **capitalization table** gives the actual and *pro forma* (adjusted) financial position of the issuer for before and after it receives the funds from the offering. Read the footnotes to this table carefully.

The **dilution section** sets out the price at which shares in the company have been acquired and will be acquired in this offering. It contrasts the price per share paid by existing shareholders with the present offering price and contrasts the per share tangible book value (the value you will receive in your shares after the offering) with the offering price (that you will pay for those shares).

The **dividend policy** will reveal whether the stock is income or growth oriented. If income oriented, there should be a history of paying dividends. If growth oriented, there is generally no track record of dividend payments. Some companies may be restricted by their creditors from paying dividends. If you need income, don't invest in a security that doesn't pay dividends.

The **selected consolidated financial information** is an expansion of the financial information appearing in the summary information, but substantially less than that found in the financial statements and footnotes.

Management discussion and analysis of financial condition and results of operations is one of the most important sections in the prospectus, particularly if you have trouble following the financial statements. This section will tell you how management feels it has performed and gives some idea how the business is "trending" with the economy. Careful reading will reveal positive or negative trends on revenues, earnings and expenses. It pays to read this section closely to see where

the issuer has been and where it might be going after the new capitalization.

Business is an expanded section of the information outlined under the "Company" heading and should provide more detailed disclosure as to the issuer's history, business plan and method(s) of operation. This section contains a subsection entitled "Competition." It is worthwhile to note who and what constitutes the competition against the issuer. This section will also have additional subsections such as Properties, Employees, Patents and Service Marks, and Legal Proceedings.

The **Management** section lists the directors and executive officers, and gives their ages, positions and past experience. It also names the founders or promoters. In the subsection on compensation plans, note any special option plans, stock appreciation rights or other similar common stock equivalents to be paid to management or employers. These equivalents may provide necessary incentives to the employees, management and officers and directors, but an exceptionally larger number may eventually depress the price of your stock.

The **certain transactions** section discloses transactions between and among the issuer, principals and affiliates. Such transactions should be viewed skeptically since they can siphon operating capital and offering proceeds away from the business. Keep an eye open for questionable loans and promissory notes, use of business properties for personal benefit, less-than-competitive sales or acquisitions of plant and equipment or securities.

The **description of capital stock** section details the classes of stock and their voting rights. The

section indicates which securities are authorized, issued and outstanding. This section provides insight as to the total supply of stock available for sale, which may increase and consequently depress the price of your stock (if earnings are poor or declining).

The **underwriting** section discloses the form of underwriting used and the amount of compensation the underwriter will receive. Firm underwriting is an underwriting in which the brokerage firm commits to buy the entire issue of stock being offered and therefore assumes all financial responsibility for any shares that go unsold. In a best efforts underwriting, the brokerage firm acts as an agent at the corporation and only promises to do their “best efforts” in making the offering a success. Under a best efforts underwriting, the brokerage firm does not guarantee that all the shares offered will be sold, and therefore, does not assume any financial liability if the offering is not a success. A variation of the “best efforts” underwriting is the “mini-max.” In a “mini-max” offering, the company whose shares are being offered establishes the minimum dollar amount necessary to achieve the purposes of the offering. If this amount is not met, then the entire offering is cancelled and all of the investors’ funds are returned. A recent variation of the “mini-max” offering is the “all or none” offering. This form of underwriting, as its name implies, provides that the minimum amount of capital required can only be met by the sale of all shares being offered. If this amount is not sold, then the offering is cancelled.

This section also discloses whether the underwriter receives an option as compensation. Usually options are granted to underwriters as

compensation when the issuer is small, new or weak. Note any finder's fees or other special consideration for selling the security. Keep in mind that more compensation to the underwriter (and for organizational expenses) means less proceeds available to the issuer for business purposes. Generally, a sales commission in the range of 6-10% (plus any underwriters' options, and organization and offering costs in the neighborhood of 5%) is normal.

The **legal matters** and **experts** sections will indicate who performed the legal work on the offering and which accounting firms and other professionals participated. Parties listed in legal matters and experts have third-party liability in connection with the offering.

Report of independent accountants is the auditors' opinion. Read it carefully for any qualification relating to management reporting practices that do not conform to generally accepted accounting principles. If the opinion mentions any specific footnotes to the financials, be sure to read them. Note the age of the financials, the date of which will appear under the accountant's signature.

Financial statements and **footnotes**, which includes the balance sheet, income statement, and statement of changes in financial position will provide strong insights into the business operations of the issuer, its solvency and any unique characteristics. The footnotes following the financials generally include operations, summary of significant accounting policies, inventories, property and equipment, leases, short-term borrowings and long-term debt, employee benefit plans, income taxes, related party transactions, litigation (if any),

subsequent events (unaudited), authorization of common and preferred stock

Signposts of value

Look for signposts of value, a process frequently referred to as fundamental analysis. Search for the following strong fundamentals that indicate value:

The **offering price**. The offering price should reasonably relate to the earnings per share, to similar companies already in the market and to the *Standard and Poor's* price earnings ratio for the market. If the price is higher, the stock may be overpriced. Don't pay more than the stock is really worth or will be worth within a reasonable amount of time. The offering price must also generate sufficient new funds to accomplish the purpose of the offering.

Use of proceeds. Look at the intended use of proceeds from the offering. If there is no particular specified use for the money being raised, the offering may be a "blind pool." Don't turn your money over to something without knowing how, in very specific terms, it will be used. Securities scams frequently involve entities with no particular plan of business.

Risk factors. ("Certain Considerations") The title is a polite "tip off" to items you need to carefully consider as you read through the offering document. The items listed at the front of the prospectus are frequently the most risky features of the financing. Keep your eyes open for contingent liabilities that could affect the company after you've bought into it.

Age and track record of the company. Evaluate whether management has the experience and expertise to make the company a successful

venture. Note the company's age and its past success rate and how efficiently the company achieves its objectives (business costs versus revenues). Look at the trends the company faces in light of its history to judge whether this offering will be a success or failure. Take special notice of whether earnings are steady or erratic or whether they radically changed one way or the other recently. If there has been such a change, find out the reasons for it.

Capitalization of the issuer. Check to see how much the issuer is worth. Start with the capitalization table and its footnotes in conjunction with the balance sheet and footnotes. The footnotes to the capitalization table provide a good summary of any common stock equivalents that exist. The amount of common stock or common stock equivalent that exists will directly effect the value of your common stock. The greater the pool of outstanding stock, the greater is the amount of earnings required to maintain or increase the price of the stock. Common stock equivalents may depress the price of your stock when converted to common stock, because that conversion increases the size of the pool, and the earnings may be insufficient to maintain the per share price at the pre-conversion level.

Check the amount of short-term, long-term and total debt, and review how much of each is carried on the books as a liability and when each type comes due. The issuer may have revolving credit lines or may be financing itself (in addition to your investment) by some type of trade receivables. Check to see if the issuer's income is sufficient to pay its expenses. Particularly, note whether the

issuer can pay its debts as they come due or whether it has borrowed too much. The issuer may have borrowed so much that even with the funds from this offering there will still be difficulty paying debts as they come due. Stay away from an issuer that has borrowed too much money, whose expenses are rapidly increasing, whose earnings are rapidly decreasing, or whose capital costs are greater than the ability to generate funds.

Ask yourself whether this new issue or financing will generate sufficient funds to accomplish the offering's stated purpose. If not, why not? How long will the new funds carry the business before the business will have to find even more funds? Realistically, a public company can't issue stock or bonds more often than every 12-18 months, if that often. Check the auditor's opinion to see if it carries any kind of qualification as to the ability of the issuer to survive and continue in business. There are different kinds of qualifications, but one of the most serious is whether or not the issuer has the ability to remain a "going concern" (remain in business). If the information disclosed tends to suggest a possibility of failure it would be wise to seek a different investment.

Management of company. Examine how much experience in this type of business the management brings to the company and how much time each member of management will devote to the company. If the principals are not experienced or do not plan to devote their full time to the company, find a different investment.

Warning signs

Insiders are getting out. The section after the management section indicates the amount of ownership of any of the principals and any other 5% or

greater owners. By looking at this table and at principal and selling shareholders, you can tell whose ownership is changing because of the offering. If the company is not doing well and a number of the original investors are selling out, they may know something you don't. Try to figure out how much money the founders and early investors contributed to the company. To do this, check the same information you looked at to see what the company is worth, together with the dilution table. This will tell you how much the founders and early investors paid to the company versus how much you and the new investors are being asked to pay. If the original investors paid little, the company hasn't performed well or hasn't been around very long and you are paying significantly more than they did, you may not be getting much value for your dollar. These conditions are even more negative if the original investors are selling out.

Excess compensation. Check the compensation table, called "executive compensation," usually a subsection of the management section. Check for any information on stock options and benefit plans found in the "compensation pursuant to plans" subsection. If management is only part-time and receiving huge salaries and benefits or stock options, find a different company to invest in.

"Sweetheart deals." Check the "certain transactions" section to see what kinds of affiliated transactions are being engaged in by management and the issuer's principals. Are there any "sweetheart" contracts, land sales, personal use of company assets or questionable loans from the company to these parties? Are these transactions competitive and in the best interest of the company? Some

of these transactions may not be in the best interest of the company and may constitute misappropriation of the company's assets.

Unexplained change in accounting methods. Certain accounting practices or changes will be disclosed in the footnotes to the financials. These practices or changes may make revenues and expenses appear different from what they really are. Although some such changes will make sense from a business standpoint, be sure that they weren't made simply to gloss over grim financial news.

Offering features that should make you skeptical:

No stated business purpose or plan.

No specific use of proceeds.

No specific restrictions on the use of the funds.

A small aggregate offering amount, usually in the range of $75,000 to 250,000.

Low offering share price, usually 1 to 10 cents.

Inexperienced management.

Limited time commitment by management.

Little or no operating "track record."

Unaudited financials, or financials that bear qualified opinions.

Inadequate or difficult to obtain information or disclosure.

Words to the wise

Teach yourself to be a value shopper. Leave the urge to bet on the "longshot" at the track. If you do decide to gamble rather than invest, be prepared to lose your money. Always remember there are no guarantees and that there is always risk, no matter what anyone tells you.

Services of Missouri Division of Securities

The Missouri Securities Division is a division of the Office of the Secretary of State. The Securities Division registers securities offerings and licenses the individuals who sell them. The staff of the Division is available to answer questions, receive complaints or check licenses and disciplinary history between the hours of 8:00 a.m. and 5:00 p.m. The office is located in Room 229 of the James C. Kirkpatrick State Information Center in Jefferson City.

Inquiries about securities offerings:
(573) 751-4136

Inquiries about salespersons licenses:
(573) 751-2061

Complaints and Questions:
(573) 751-4704

Toll-free hotline:
(800) 721-7996

Missouri Securities Division
Office of the Secretary of State
James C. Kirkpatrick State Information Center
PO Box 1276
Jefferson City, Mo. 65102-1276